

Financial Statements

Auditor Independence

The Board of Governors engaged Deloitte & Touche LLP (D&T) to audit the 2012 combined and individual financial statements of the Reserve Banks and those of the consolidated LLC entities.¹ In 2012, D&T also conducted audits of internal controls over financial reporting for each of the Reserve Banks, Maiden Lane LLC, Maiden Lane III LLC, and TALF LLC. Fees for D&T's services totaled \$7 million, of which \$1 million was for the audits of the consolidated LLC entities. To ensure auditor independence, the Board requires that D&T be independent in all matters relating to the audits. Specifically, D&T may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2012, the Bank did not engage D&T for any non-audit services.

¹ In addition, D&T audited the Office of Employee Benefits of the Federal Reserve System (OEB), the Retirement Plan for Employees of the Federal Reserve System (System Plan), and the Thrift Plan for Employees of the Federal Reserve System (Thrift Plan). The System Plan and the Thrift Plan provide retirement benefits to employees of the Board, the Federal Reserve Banks, and the OEB.

FEDERAL RESERVE BANK *of* CLEVELAND

Cleveland, Ohio 44101
216.579.2000

Management's Report on Internal Control Over Financial Reporting

March 14, 2013

To the Board of Directors of the Federal Reserve Bank of Cleveland:

The management of the Federal Reserve Bank of Cleveland (Bank) is responsible for the preparation and fair presentation of the Statements of Condition as of December 31, 2012 and 2011, and the Statements of Income and Comprehensive Income, and Statements of Changes in Capital for the years then ended (the financial statements). The financial statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System as set forth in the *Financial Accounting Manual for Federal Reserve Banks* (FAM), and, as such, include some amounts that are based on management judgments and estimates. To our knowledge, the financial statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the FAM and include all disclosures necessary for such fair presentation.

The management of the Bank is responsible for establishing and maintaining effective internal control over financial reporting as it relates to the financial statements. The Bank's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with the FAM. The Bank's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the Bank's assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with FAM, and that the Bank's receipts and expenditures are being made only in accordance with authorizations of its management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Bank's assets that could have a material effect on its financial statements.

Even effective internal control, no matter how well designed, has inherent limitations, including the possibility of human error, and therefore can provide only reasonable assurance with respect to the preparation of reliable financial statements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The management of the Bank assessed its internal control over financial reporting based upon the criteria established in the *"Internal Control – Integrated Framework"* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, we believe that the Bank maintained effective internal control over financial reporting.

Federal Reserve Bank of Cleveland



Sandra Pianalto
President &
Chief Executive Officer



Gregory L. Stefani
First Vice President &
Chief Operating Officer



Susan M. Steinbrink
Senior Vice President &
Chief Financial Officer

INDEPENDENT AUDITORS' REPORT

To the Board of Governors of the Federal Reserve System
and the Board of Directors of the Federal Reserve Bank of Cleveland:

We have audited the accompanying financial statements of the Federal Reserve Bank of Cleveland ("FRB Cleveland"), which are comprised of the statements of condition as of December 31, 2012 and 2011, and the related statements of income and comprehensive income, and of changes in capital for the years then ended, and the related notes to the financial statements. We also have audited the FRB Cleveland's internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Management's Responsibility

The FRB Cleveland's management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles established by the Board of Governors of the Federal Reserve System (the "Board") as described in Note 3 to the financial statements. The Board has determined that this basis of accounting is an acceptable basis for the preparation of the FRB Cleveland's financial statements in the circumstances. The FRB Cleveland's management is also responsible for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. The FRB Cleveland's management is also responsible for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements and an opinion on the FRB Cleveland's internal control over financial reporting based on our audits. We conducted our audits of the financial statements in accordance with auditing standards generally accepted in the United States of America and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States) ("PCAOB") and we conducted our audit of internal control over financial reporting in accordance with attestation standards established by the American Institute of Certified Public Accountants and in accordance with the auditing standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement and whether effective internal control over financial reporting was maintained in all material respects.

An audit of the financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the FRB Cleveland's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit of the financial statements also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. An audit of internal control over financial reporting involves obtaining an understanding

of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

Definition of Internal Control Over Financial Reporting

The FRB Cleveland's internal control over financial reporting is a process designed by, or under the supervision of, the FRB Cleveland's principal executive and principal financial officers, or persons performing similar functions, and effected by the FRB Cleveland's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the accounting principles established by the Board. The FRB Cleveland's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the FRB Cleveland; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the accounting principles established by the Board, and that receipts and expenditures of the FRB Cleveland are being made only in accordance with authorizations of management and directors of the FRB Cleveland; and (3) provide reasonable assurance regarding prevention or timely detection and correction of unauthorized acquisition, use, or disposition of the FRB Cleveland's assets that could have a material effect on the financial statements.

Inherent Limitations of Internal Control Over Financial Reporting

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected and corrected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Opinions

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the FRB Cleveland as of December 31, 2012 and 2011, and the results of its operations for the years then ended in accordance with the basis of accounting described in Note 3 to the financial statements. Also, in our opinion, the FRB Cleveland maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

Basis of Accounting

We draw attention to Note 3 to the financial statements, which describes the basis of accounting. The FRB Cleveland has prepared these financial statements in conformity with accounting principles established by the Board, as set forth in the *Financial Accounting Manual for Federal Reserve Banks*, which is a basis of accounting other than accounting principles generally accepted in the United States of America. The effects on such financial statements of the differences between the accounting principles established by the Board and accounting principles generally accepted in the United States of America are also described in Note 3 to the financial statements. Our opinion is not modified with respect to this matter.



March 14, 2013

STATEMENTS OF CONDITION

As of December 31, 2012 and December 31, 2011 (in millions)

	2012	2011
ASSETS		
Gold certificates	\$ 515	\$ 450
Special drawing rights certificates	237	237
Coin	145	173
System Open Market Account:		
Treasury securities, net (of which \$232 and \$408 is lent as of December 31, 2012 and 2011, respectively)	45,997	47,279
Government-sponsored enterprise debt securities, net (of which \$18 and \$34 is lent as of December 31, 2012 and 2011, respectively)	2,021	2,913
Federal agency and government-sponsored enterprise mortgage-backed securities, net	24,161	22,913
Foreign currency denominated assets, net	1,846	1,925
Central bank liquidity swaps	657	7,405
Other investments	1	—
Accrued interest receivable	482	534
Bank premises and equipment, net	128	137
Items in process of collection	8	59
Interdistrict settlement account	3,671	—
Other assets	33	28
Total assets	<u>\$ 79,902</u>	<u>\$ 84,053</u>
LIABILITIES AND CAPITAL		
Federal Reserve notes outstanding, net	\$ 52,504	\$ 45,046
System Open Market Account:		
Securities sold under agreements to repurchase	2,725	2,698
Other liabilities	81	37
Deposits:		
Depository institutions	20,154	26,962
Other deposits	3	3
Interest payable to depository institutions	2	3
Accrued benefit costs	133	121
Deferred credit items	3	142
Accrued interest on Federal Reserve notes	17	82
Interdistrict settlement account	—	4,966
Other liabilities	12	15
Total liabilities	<u>75,634</u>	<u>80,075</u>
Capital paid-in	2,134	1,989
Surplus (including accumulated other comprehensive loss of \$20 and \$11 at December 31, 2012 and 2011, respectively)	2,134	1,989
Total capital	<u>4,268</u>	<u>3,978</u>
Total liabilities and capital	<u>\$ 79,902</u>	<u>\$ 84,053</u>

The accompanying notes are an integral part of these financial statements.*

STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

For the years ended December 31, 2012 and December 31, 2011 (in millions)

	2012	2011
INTEREST INCOME		
System Open Market Account:		
Treasury securities, net	\$ 1,201	\$ 1,213
Government-sponsored enterprise debt securities, net	68	89
Federal agency and government-sponsored enterprise mortgage-backed securities, net	815	1,115
Foreign currency denominated assets, net	10	18
Central bank liquidity swaps	18	3
Total interest income	2,112	2,438
INTEREST EXPENSE		
System Open Market Account:		
Securities sold under agreements to repurchase	4	1
Deposits:		
Depository institutions	44	55
Total interest expense	48	56
Net interest income	2,064	2,382
NON-INTEREST INCOME		
System Open Market Account:		
Treasury securities gains, net	342	61
Federal agency and government-sponsored enterprise mortgage-backed securities gains, net	6	—
Foreign currency translation (losses) gains, net	(82)	11
Compensation received for service costs provided	15	25
Reimbursable services to government agencies	25	52
Other	4	4
Total non-interest income	310	153
OPERATING EXPENSES		
Salaries and benefits	111	142
Occupancy	14	16
Equipment	6	7
Assessments:		
Board of Governors operating expenses and currency costs	77	70
Bureau of Consumer Financial Protection	30	18
Office of Financial Research	—	3
Other	25	33
Total operating expenses	263	289
Net income before interest on Federal Reserve notes expense remitted to Treasury	2,111	2,246
Interest on Federal Reserve notes expense remitted to Treasury	1,831	2,132
Net income	280	114
Change in prior service costs related to benefit plans	(4)	19
Change in actuarial (losses) gains related to benefit plans	(5)	7
Total other comprehensive (loss) income	(9)	26
Comprehensive income	\$ 271	\$ 140

The accompanying notes are an integral part of these financial statements.*

STATEMENTS OF CHANGES IN CAPITAL

For the years ended December 31, 2012 and December 31, 2011 (in millions, except share data)

	Surplus				
	Capital paid-in	Net income retained	Accumulated other comprehensive loss	Total surplus	Total capital
Balance at December 31, 2010 (39,350,384 shares)	\$ 1,967	\$ 2,004	\$ (37)	\$ 1,967	\$ 3,934
Net change in capital stock issued (422,697 shares)	22	—	—	—	22
Comprehensive income:					
Net income	—	114	—	114	114
Other comprehensive income	—	—	26	26	26
Dividends on capital stock	—	(118)	—	(118)	(118)
Net change in capital	22	(4)	26	22	44
Balance at December 31, 2011 (39,773,081 shares)	\$ 1,989	\$ 2,000	\$ (11)	\$ 1,989	\$ 3,978
Net change in capital stock issued (2,911,715 shares)	145	—	—	—	145
Comprehensive income:					
Net income	—	280	—	280	280
Other comprehensive loss	—	—	(9)	(9)	(9)
Dividends on capital stock	—	(126)	—	(126)	(126)
Net change in capital	145	154	(9)	145	290
Balance at December 31, 2012 (42,684,796 shares)	\$ 2,134	\$ 2,154	\$ (20)	\$ 2,134	\$ 4,268

The accompanying notes are an integral part of these financial statements.*

* Read the accompanying notes on our website at www.clevelandfed.org/annualreport.